Supreme Court, U.S.
FILED

(1)

98 358 AUG 28 1998

No. OFFICE OF THE CLERK

In The

Supreme Court of the United States

October Term, 1997

RELIANCE INSURANCE CO., a Pennsylvania Corporation,

Petitioner,

vs.

U.S. BANK OF WASHINGTON, N.A., a National Banking Association,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR WRIT OF CERTIORARI

JOHN C. MERKEL
Attorney for Petitioner
999 Third Avenue
Suite 2525
Seattle, Washington 98104
(206) 389-8222

147837 (800) 274-3321 • (800) 359-6859
COUNSEL PRESS

5112

QUESTIONS PRESENTED

Whether, after notice by a Miller Act Surety of a contractor's default and the surety's claim of an equitable lien in the funds in the contractor's general account traceable from a federal project payment, a bank, with only an Article 9 U.C.C. security interest in receivables, may offset those funds to pay down the contractor's general line of credit?

Whether a bank "receives" payment from offsetting the contractor's account on the date of deposit to the contractor's account or the date on which the bank actually makes the offset and notates it on the books of the contractor's account?

PARTIES TO THE PROCEEDINGS

PETITIONER

Party: Reliance Insurance Company

Parent Company: Reliance Group Holdings Corp.

Publicly Owned Affiliates: United Pacific Insurance Co.; Reliance National Indemnity Co.; Reliance Surety Co.; Reliance Reinsurance Corp.

RESPONDENT

Party: U.S. Bank of Washington National Association

Parent Company: U.S. Bancorp

Subsidiary: U.S. Bancorp Capital Corporation

Publicly Owned Affiliate: U.S. Bancorp

TABLE OF CONTENTS

	Page
Questions Presented	i
Parties to the Proceedings	ii
Table of Contents	iii
Table of Cited Authorities	iv
Opinions Below	1
Statement of Jurisdiction	1
Statement of the Case	1
A. Background of the District Court Judgment	2
B. The Proceedings Below	5
Reasons for Granting the Writ	7
I. The Petition Should Be Granted Because The Ninth Circuit Opinion Conflicts With First And Fifth Circuit Opinions Which Use The Date Of Offset As The Operative Date To Determine Whether The Bank's Knowledge Bars Its Right To Offset.	7
II. The Petition Should Be Granted Because The Opinion Conflicts With This Court's Ruling In *Martin v. National Surety Company*, 300 U.S. 588, 57 S. Ct. 531 (1937) Allowing A Surety To	

Page

Trace Project Funds To The Account Of A Contractor And To Recover Those Funds, Which Are Impressed With A Constructive Trust, From Whoever May Have Received Them With Notice Of The Facts Giving Rise To The Surety's Interest. 13

Conclusion 20

TABLE OF CITED AUTHORITIES

Cases Cited:

Aetna Casualty Insurance Company v. Harvard Trust, 344 Mass. 160, 181 N.E. 2nd 673 Mass. (1962) ... 19

Allied Sheet Metal Fabricators, Inc. v. Peoples National Bank of Washington, 10 Wash. App. 530, 518 P.2d 734, *cert. denied,* 419 U.S. 967, 95 S. Ct. 231, 42 L. Ed. 2d 183 (1974) 12

Bank of Arizona v. National Surety Corporation, 237 F.2d 90 (9th Cir. 1956) 6

In re Massart Company, 105 B.R. 610 (W.D. Wash. 1989) 15, 16

Insurance Company of North America v. Northampton National Bank, 708 F.2d 13 (1st Cir. 1983) 8, 9, 20

Johnson Services Company v. Roush, 57 Wash. 2d 80 16

Table of Cited Authorities

Page

Martin v. National Surety Company, 300 U.S. 588, 57 S. Ct. 531 (1937) 5, 13, 14, 16, 17, 19

Pacific Indemnity Company v. Grand Avenue State Bank of Dallas, Texas, 223 F.2d 513 (5th Cir. 1955) 7, 10, 14, 15, 19

Pearlman v. Reliance Insurance Company, 371 U.S. 132, 83 S. Ct. 322 (1962) 13

Peoples National Bank of Washington v. United States, 777 F.2d 459 (9th Cir. 1985) 11, 12, 14

United States Fidelity and Guaranty Company v. City of Bristow, 4 F.2d 810 (E.D. Okla. 1925) 19

Statutes Cited:

28 U.S.C. § 1254(1) 1

40 U.S.C. § 270A 2

41 U.S.C. § 15 ..... 3, 10

Revised Code of Washington 62A.9-101 *et seq.* 1

Other Authorities Cited:

Clark, B. Law of Bank Deposits, Collections and Credit Cards, revised edition § 3.09(4) 10, 11

Uniform Commercial Code Article 9 ..... 1, 3, 5, 10

APPENDIX

Page

Appendix A — Opinion Of The United States Court Of Appeals For The Ninth Circuit Filed April 29, 1998 ..... 1a

Appendix B — Judgment Of The United States Court Of Appeals For The Ninth Circuit Filed April 29, 1998 ..... 12a

Appendix C — Transcript Of Proceedings Dated May 4, 1995 ..... 13a

Appendix D — Order Of The United States Court Of Appeals For The Ninth Circuit Denying Petition For Rehearing En Banc Filed June 16, 1998 ..... 20a

Petitioner Reliance Insurance Company respectfully requests a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Ninth Circuit is recorded as *Reliance v. U.S. Bank*, 143 F.3d 502 (9th Cir. 1998) (App. A). The judgment of the United States Court of Appeals for the Ninth Circuit was entered on April 29, 1998 (App. B). The opinion of the District Court in *Reliance Insurance Company v. U.S. Bank*, Civ. No. C93-705Z (W.D. Wash. May 4, 1995) is not published (App. C). The order of the United States Court of Appeals for the Ninth Circuit denying Petition for Rehearing and for Rehearing En Banc was entered on June 16, 1998 (App. D).

STATEMENT OF JURISDICTION

The judgment of the United States Court of Appeals for the Ninth Circuit ("Court of Appeals") was entered on April 29, 1998. The Court of Appeals denied a timely petition for rehearing on June 16, 1998 (App. C).

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATEMENT OF THE CASE

The issue in this case is whether a bank with an Article 9 U.C.C. (Revised Code of Washington 62A.9-101 *et seq.*) security interest may offset funds from a contractor's account to satisfy a debt from the contractor to the bank on a general line of credit where: (1) at the time the contractor is in default

(June 19, 1992) he receives a payment from the government and deposits it in his bank account; (2) the Surety thereafter notifies the bank of the default and the Surety's equitable claim to the funds in the contractor's account (June 23, 1992); (3) the funds in the contractor's account are directly traceable to the government project; (4) the bank thereafter exercises offset (June 24, 1992).

A. Background of the District Court Judgment

On September 27, 1991 the Gordon Kruse Construction Company ("Kruse") entered into a contract with the United States Coast Guard to construct improvements for a total cost of $2,944,000.

On October 9, 1991 pursuant to the provisions of the Miller Act, 40 U.S.C. § 270A Reliance Insurance Company ("Reliance") posted a payment bond in the amount of $1,7177,600 and a performance bond in the amount of $2,944,000.

On March 16, 1990 Kruse had signed a "continuing agreement of indemnity-contractor's form," section 4d of which provided in part:

> 4. To assign, transfer and convey and each of the undersigned does by these presence assign, transfer and convey to the Surety as of the date of execution of said bond, as collateral for the full performance of the covenants and agreements herein contained . . . the following: All right, title and interest of the undersigned in and to any and all estimated payments, extras, final payments and other sums that, at the time of . . . breach of said contract or such bond or bonds, or at the time of any advance,

> payment or guaranty by Surety for the purpose of avoiding . . . such breach maybe due or may thereafter become due under the contract to or on behalf of the undersigned . . .

In addition section 6 of the indemnity agreement reads as follows:

> That the entire contract price of any contract referred to in a bond or bonds, *whether in the possession of the undersigned or another*, shall be and hereby is impressed with a trust in favor of the Surety for the payment of obligations incurred for labor, material and services in the performance of the work for which surety would be liable under such bond or bonds and for the purpose of satisfying the conditions of the bond executed in connection with the contract.

On January 31, 1992 Kruse entered into a loan agreement with U.S. Bank which provided him with a $1,000,000 revolving line of credit. Funds drawn from this line of credit could be used on any construction job which Kruse undertook or for any other purpose Kruse chose. U.S. Bank did not control Kruse's use of the funds in the credit line. As security for the revolving line of credit U.S. Bank took an Article 9 U.C.C. security interest in Kruse's accounts, general intangibles, inventory and equipment. U.S. Bank did not comply with 41 U.S.C. § 15 concerning assignments of funds from federal contracts.

Kruse and the Coast Guard arranged for all payments from the Coast Guard to be wired directly into Kruse's Construction account located at U.S. Bank.

In March 1992 Kruse became delinquent on payments to subcontractors. In its April 30 and May 29, 1992 draw requests Kruse falsely certified that certain subcontractors had been paid when they had not in fact been paid. Between June 3 and June 19, 1992 Reliance Insurance Company ("Reliance") became aware of approximately $289,373.49 in claims on the Coast Guard project.

On June 22, 1992 Reliance, aware of a payment due to Kruse, attempted to stop the payment from going to Kruse. Only then did Reliance discover that Kruse's progress payments were being paid by direct wire deposits from the government. On June 19, 1992 a direct deposit to Kruse's account in the amount of $280,319 was made by the Coast Guard. On June 22 Reliance was presented with a financial spread sheet provided by Kruse's attorney which showed a deficit of over 1.5 million dollars on the Reliance bonded projects. The spread sheet showed that vendors on the Coast Guard project were owed $595,503 and that even if the $280,319 draw were applied the deficit would still be $290,392.

On June 22 Kruse advised Reliance that he could not complete the Coast Guard project. On June 22 Reliance requested that Kruse execute a letter to each project owner stating he could no longer perform his contract, was waiving his right to written notice of default and authorizing all payments of any sort to be made to Reliance. A copy of this request was received by U.S. Bank from Kruse's attorney on June 23, 1992.

On June 23, 1992 the attorneys for Kruse presented to U.S. Bank the same financial information that had been presented to Reliance on June 22, 1992. In addition, U.S. Bank was provided on June 23, 1992 with two faxes from Reliance wherein Reliance requested that the June 19, 1992 wire deposit of $280,319 from the Coast Guard be used to pay suppliers and

subcontractors on the Coast Guard project. On June 23, 1992 Reliance personnel contacted U.S. Bank personnel and advised them of the equitable claim of Reliance to the $280,319 deposit in Kruse's account. On June 24, 1992 U.S. Bank made a set off to Kruse's account of $280,319 which it applied to Kruse's debt to U.S. Bank on the general revolving line of credit. Other, smaller offsets were also made but those were not traceable to any immediate deposit. The $280,319 is traceable and is stated on the bank statement of the Kruse account as having originated from the United States Coast Guard.

B. The Proceedings Below

On May 5, 1995 this matter was brought before United States District Court on cross motions for summary judgment on stipulated facts.

The District Court based on the stipulated facts found that the Coast Guard had wired $280,319 into the contractor's account on June 19, 1992 and that on June 23, 1992 the bank knew of Kruse's default and inability to finish the job for the Coast Guard. The court further found that the bank on June 24, 1992 directed an offset of $280,319 to lower the outstanding balance on the line of credit. The court found that the surety had an equitable lien on those funds which was superior to the bank's security interest under Article 9 of the Uniform Commercial Code. The court then found that the bank had converted the funds when it made the offset with full knowledge of the surety's equitable lien on those funds. The District Court cited *Martin v. National Surety Company*, 300 U.S. 588, 57 S. Ct. 531 (1937) for the proposition that a creditor wrongfully receives payment from a contractor when the creditor receives the payment with knowledge or notice of a Miller Act Surety's equitable lien on the funds. The court noted that it would not be wrongful for the creditor to receive payment if the creditor

had no knowledge of the Miller Act Surety's equitable lien and cited *Bank of Arizona v. National Surety Corporation*, 237 F.2d 90 (9th Cir. 1956). The District Court decision determined that the bank had "wrongfully received" the $280,319 by exercising offset on June 24, 1992 after it had knowledge of the contractor's default and surety's claim of equitable lien and had thus converted the surety's funds. (App. C, page 16a).

On Appeal the court phrased the issue as: "This is a dispute between a bank and a surety over which of them gets a government payment into a defaulting contractor's bank account." (App. A, page 2a). The court set the stage for its decision by then stating: "The money at issue in this case was paid out June 19, 1992. On that date the Coast Guard deposited $280,319 into the contractor's bank account by wire transfer." (App. A, page 3a).

The court decided that the bank, not Kruse, received the money on June 19, 1992 when the Coast Guard wired it into the contractor's account, and at that time had no obligation to deliver it to the surety because it had no knowledge of any claim by the surety to the funds on June 19, 1992. By virtue of its decision that the money was received by the bank on June 19, 1992 rather than on June 24, 1992 when the setoff and notation thereof occurred, the Ninth Circuit found there was no conversion since funds were not "wrongfully received" by the bank and said "nor did the bank, when it received the money on June 19, have any obligation to deliver it to another." (App. A, page 6a). The court held it appropriate for the bank "to treat the June 19 progress payment as a setoff against what the contractor already owed the bank." (App. A, page 3a).

The court held there was no constructive trust in favor of the surety as against the contractor's bank account because the bank account was merely an acknowledgment of debt from the

bank to the contractor and that the bank had "received the wire transfer without any knowledge that would impose a trust on the funds at the time the bank received the transfer."

REASONS FOR GRANTING THE WRIT

I.

THE PETITION SHOULD BE GRANTED BECAUSE THE NINTH CIRCUIT OPINION CONFLICTS WITH FIRST AND FIFTH CIRCUIT OPINIONS WHICH USE THE DATE OF OFFSET AS THE OPERATIVE DATE TO DETERMINE WHETHER THE BANK'S KNOWLEDGE BARS ITS RIGHT TO OFFSET.

There is a direct conflict between decisions of the First and Fifth Circuits which hold that the bank's lack of knowledge of the surety's claim to the funds on the date of deposit is immaterial and that it is the knowledge of the bank at the time of making the offset notation in the customer's records that determines, as between the surety and a bank, the right to the funds setoff, and the decision of the Ninth Circuit which held below that where a bank receives a deposit to a customer's account without knowledge of the surety's claim it may later offset the funds using the date of deposit as the date of receipt and thus avoid the bar to offset which the knowledge of the surety's claim, received after deposit but before the bank offsets, would otherwise place in effect under the First and Fifth Circuit opinions.

In *Pacific Indemnity Company v. Grand Avenue State Bank of Dallas, Texas*, 223 F.2d 513 (5th Cir. 1955) a contractor, despite a restraining order, deposited a check in his bank account on August 22, 1953. On August 26, 1953 the surety's attorney advised the bank of the restraining order prohibiting the

contractor from depositing or spending the proceeds of the check. Shortly thereafter the bank declared the contractor's indebtedness due and payable and setoff the balance against the bank's debt.

The Fifth Circuit held that the bank was not entitled to keep the funds from the setoff. The Court found the funds were impressed with a trust in favor of the surety for the reason that the

> appellant's (surety's) rights to the proceeds of any contract payment . . . matured through Sharrock's (contractor) default. . . . the check when received and deposited was impressed with a constructive trust in favor of Appellant.

Id. at 518. The Court held that the bank's lack of knowledge at the time of deposit did not effect the surety's right to recover the money, saying,

> While it is true that the bank had no knowledge of the assignment or of Sharrock's default when the check was deposited, the fact remains that before the offset it knew that Appellant, surety company, had enjoined Sharrock's expenditure of any contract funds and it had actually received a copy of the restraining order.

Id. at 518.

Similarly in *Insurance Company of North America v. Northampton National Bank,* 708 F.2d 13 (1st Cir. 1983) a contractor made a deposit of a progress payment on October 6. The contractor had been in default as of October 1, but the bank had no knowledge of the default when the funds were deposited on October 6. On October 15 the attorney for the

contractor advised the bank that the contractor was in default. On October 18 the bank setoff the funds in the contractor's account and applied them against the contractor's loan. The First Circuit phrased the issue in terms most favorable to the bank as follows:

> Was (the contractor) in default before October 6, maturing (the surety's) claim before the check was received and did the bank learn of this prior to effecting the setoff on October 18?

Id. at 15.

The courts in both the Fifth and First Circuits restored the money to the surety. In the instant case it was stipulated that the funds from the Coast Guard job were wire transferred for deposit to the contractor's bank account on June 19, 1992. It was stipulated that the contractor was in default prior to June 19, 1992, but that the bank did not know of that default until June 23, 1992. In its opinion the court noted that the bank chose to treat the June 19 progress payment as a setoff against what the contractor owed the bank and that "the surety argues that the bank lost its setoff right once the surety asserted its claim, so the bank setoff came too late . . ." (App. A, page 9a). Despite the surety's argument that the notice of June 23, 1992 from the surety to the bank barred the bank from offsetting the funds against its debt on June 24, 1992, the court held the bank entitled to the money set off because the bank's knowledge , or lack thereof, of the surety's claims as of June 19 (date of deposit) not June 24 (date of offset) was dispositive of who should get the funds from the account: "nor did the bank when it received the money, June 19, have any obligation to deliver it to another." (App. A, page 6a).

The Ninth Circuit, contrary to the First and Fifth Circuits, has now held that once a progress payment is deposited to a

contractor's account, as long as on the date of deposit the bank had no knowledge of the contractor's default, then even after receiving knowledge of the contractor's default and surety's claim the bank may retroactively offset the funds as of the date of deposit.

The only security held by the bank for its million dollar line of credit was an Article 9 U.C.C. security interest in the contractor's accounts and a general assignment under State law of his account. There was no compliance with 41 U.S.C. § 15 concerning assignments of funds from federal contracts. 41 U.S.C. § 15 prohibits an assignment of contract funds unless the conditions of the statute are met.

Even had there been an approved assignment under the federal statute the result should be that here the surety recovers the funds. In this case the funds were paid to the contractor not the bank (most banks require 41 U.S.C. § 15 assigned funds to be paid directly to the bank), and, unless the contractor had actually paid the bank or the bank had actually offset the funds, the bank would have been barred from offsetting or receiving the funds in the contractor's account once it had received knowledge of the surety's equitable rights to those funds as a result of the breach by the contractor and the constructive trust with which those funds were then impressed as of the date of deposit, *Pacific Indemnity Company v. Grand Avenue State Bank, supra.*

The decision below suggests that allowing the bank to keep the setoff money creates a predictable result for the parties. Such a result is neither predictable nor usual. Banks have routinely been rebuffed by the courts where they have attempted to setoff with knowledge of a third party's right or claim to the funds in a customer's account. Clark, B. Law of Bank Deposits, Collections and Credit Cards, revised edition § 3.09(4) discusses the limitations on the bank's right to setoff and notes that:

> [i]f the bank has actual knowledge of the adverse claim, or knowledge of sufficient facts to put it on inquiry, the right of setoff may well be blocked on the ground that mutuality is lacking.

Id. at 3-179.

The treatise goes on to note that:

> [t]he bank may be liable not only for improper setoff but also for conversion, with accompanying attorney fees and even punitive damages. Notice of the adverse claim to the account alters the normal debtor/creditor relationship between bank and depositor and thereby short circuits the bank's common law or statutory right of setoff. Even if the depositor's debt to the bank is mature, the bank's right of setoff is limited once it receives the knowledge of the adverse claim.

Id. at 3-180.

The court's decision that the date of deposit (June 19) not the date of offset (June 24) should determine the outcome here is clearly the reason that the court held the bank had not converted the funds by wrongfully receiving them. If the set off occurred on June 24 as the District Court held then there was conversion by the bank due to its knowledge of the surety's rights to the funds at the time of its receipt thereof.

In *Peoples National Bank of Washington v. United States*, 777 F.2d 459 (9th Cir. 1985) *Peoples* bank was attempting to justify its rights to a depositor's funds as against an IRS levy. The bank tried three arguments all of which were rejected.

In *Peoples* the bank argued that the account was not "property." The court found the debtors to have a property interest in their account. The bank then argued that its right of set off (unexercised) extinguished the debtor's property interest in the account. The bank cited *Allied Sheet Metal Fabricators, Inc. v. Peoples National Bank of Washington,* 10 Wash. App. 530, 518 P.2d 734, *cert. denied*, 419 U.S. 967, 95 S. Ct. 231, 42 L. Ed. 2d 183 (1974) as its authority. The Court held that neither *Allied Sheet Metal Fabricators, Inc. v. Peoples National Bank of Washington, supra* nor any other Washington case supported such a rule.

Finally, the Court held that *Peoples* had no perfected security interest in the account because under the Washington version of the U.C.C. bank accounts weren't covered and under common law the bank needed to control the passbook to be perfected.

The Court's conclusion was that there is:

> . . . no basis for holding that, under Washington law, a depositor loses all rights in his account simply because the bank has a right to set-off funds in the account against an indebtedness owed to the bank.

Peoples National Bank of Washington v. United States, 777 F.2d 459 at 461.

It would seem logically to follow that until setoff occurred on June 24th Kruse had an interest in its account to which the surety's equitable rights could attach. It also logically follows that if U.S. Bank was advised of Reliance's claims then its subsequent setoff was a conversion of property belonging to the surety. The Court's decision that June 19 is the date the bank received the offset funds changes the underlying principle of *Peoples National Bank of Washington v. United States, supra*

and thus illogically leads to the conclusion that no conversion occurred.

II.

THE PETITION SHOULD BE GRANTED BECAUSE THE OPINION CONFLICTS WITH THIS COURT'S RULING IN *MARTIN v. NATIONAL SURETY COMPANY*, 300 U.S. 588, 57 S. CT. 531 (1937) ALLOWING A SURETY TO TRACE PROJECT FUNDS TO THE ACCOUNT OF A CONTRACTOR AND TO RECOVER THOSE FUNDS, WHICH ARE IMPRESSED WITH A CONSTRUCTIVE TRUST, FROM WHOEVER MAY HAVE RECEIVED THEM WITH NOTICE OF THE FACTS GIVING RISE TO THE SURETY'S INTEREST.

The Miller Act surety's equitable rights are well established in the federal courts. In *Pearlman v. Reliance Insurance Company*, 371 U.S. 132, 83 S. Ct. 322 (1962) this court noted:

> traditionally sureties compelled to pay debts for their principals have been deemed entitled to reimbursement, even without a contractual promise such as the surety here had. And probably there are few doctrines better established than that a surety who pays the debt of another is entitled to all of the rights of the person he paid to enforce his right to be reimbursed. This rule widely applied in this country and generally known as the right of subrogation, was relied on by the Court of Appeals in this case.

Id. at 136. This Court then held that a surety was subrogated to the right of laborers and materialmen, the contractor and the government.

The equitable trust impressed upon the contractor's bank account at the time of default referred to in *Martin v. National Surety Company, supra* and in *Pacific Indemnity Company v. Grand Avenue State Bank, supra* is also an equitable doctrine well established by the federal courts as being one of the rights of a surety on a government contract.

The court below, while aware of the surety's argument that the

> contractor's bank account was impressed with a constructive trust in its favor from the time the contractor first breached its contract by failing to make timely payments to subcontractors,

(App. A, page 8a) dismissed this argument by stating that the bank account is merely an acknowledgment of a debt from the bank to the contractor and that there is nothing to which the constructive trust can attach.

While it is true that the standard bank/customer relationship is a relationship of a debtor (bank) to a creditor (customer) that relationship does not mean that the depositor customer has no rights in his account, *see Peoples National Bank of Washington v. United States, supra.* The customer can order others to be paid from his account by check and since the customer still has rights in the account, a lien can attach to those rights and the account can be levied.

The nature of an account changes if the account is, for instance, an account into which trust funds are deposited. In such an account, the bank's right to offset is barred where the bank knows that such funds are trust account funds. The effect of the decision below is to eliminate the constructive trust impressed upon the contractor's account at the time of his default

and to eliminate a right of the surety, which has traditionally been recognized in the federal courts.

The surety's rights have been held to be inchoate until the time of breach by the contractor and at the time of such breach are characterized as rights which attached from the date of the contract or execution of the bond (e.g. *Pacific Indemnity Company v. Grand Avenue State Bank, supra; In re Massart Company,* 105 B.R. 610 (W.D. Wash. 1989)).

In *Massart* the District Court had occasion to examine Washington law regarding the surety's equitable rights of subrogation. The contesting parties in the case were a bankruptcy trustee and a surety, both of whom wanted a progress payment. What is relevant to the instant case is that the court had to resolve when the surety's equitable rights of subrogation arose. That issue is central to this case as well. The court found that the surety's equitable lien on the progress payments extended back to the date that it executed the payment and performance bonds and was therefore superior to the property interests of the trustee. The Bankruptcy Court ruled that the surety's equitable rights dated from the time the surety had paid Massart's debts and that since the first payment arose after Massart declared bankruptcy that the trustee's lien was prior. The District Court reached the opposite conclusion stating:

> The parties in the Bankruptcy Court, acknowledged that Washington law is unclear on the priority of a surety's equitable lien . . . traditional equitable principals state that a surety receives an equitable lien on a contractor's proceeds from the moment that the surety executes its payment and performance bonds.
>
> A surety who performs under a bond upon the contractor's default has an equitable lien on funds

> held by the owner; the lien arises upon the execution of the bond, but does not become enforceable until the surety suffers a loss by making payments pursuant to the obligation under the bond.

Id. at 612.

The Court in a footnote mentioned that the only Washington case which dated a surety's right to subrogation was *Johnson Services Company v. Roush*, 57 Wash. 2d 80. That case dated the surety's rights from the date that the surety made a payment on the contractor's debts. The District Court found that case to be inapplicable for the reason that in *Johnson Services* the surety's bond application specifically called for the surety's lien to date from the date of payment. The indemnity agreement between Reliance and Kruse states that the surety's lien shall date from the date of execution of the bonds. The surety's equitable lien here was in existence as of the date of execution of the bonds and upon the default of the contractor the equitable lien attached to funds in the hands of the contractor or in the hands of a third party, and the lien of the surety was thereafter enforceable to reimburse the surety for payments made pursuant to its bonded obligation.

This Court in *Martin v. National Surety Company, supra* held that funds traceable from payments on a federal project to a contractor which were then paid to a lender who was aware of a surety's claim to those funds were recoverable by the surety and were impressed with a constructive trust in favor of those left unpaid from the date of breach (nonpayment). This Court held that the failure to pay materialmen was a default of such a nature as to impose a duty on the contractor to turn over the payments to the surety upon appropriate demand. The rationale for the decision was that if the assignment to the surety created a lien the contractor would be compelled to fulfill his duties.

The decision below gives lip service to *Martin* but finds *Martin* applicable only

> . . . in a dishonest transaction where a lender collects money from the government knowing that the contractor has promised to pay the surety ahead of the lender.

(App. A, page 8a). The court then falls back on the June 19, 1992 date of deposit and finds U.S. Bank without knowledge of any fact on June 19 which would have imposed a trust on the funds at the time they were deposited to the contractor's account.

This Court in *Martin v. National Surety Company, supra* decided the case as if the funds had been paid to the contractor, Tobin, then deposited in his bank account and thereafter paid to the lender Martin who had full knowledge of the surety's claim. This Court in upholding the surety's right to the funds referred to the surety/contractor agreement and concluded "the equities in favor of materialmen growing out of that agreement were impressed upon the funds in the possession of the Court." *Id.* at 593-594.

In this case U.S. Bank is in no different position than Martin. The funds in Kruse's account were impressed at the time of deposit with a trust in favor of those remaining unpaid in an amount in excess of $590,000. At the time of offset the bank knew of the debts, the default and the surety's claim.

The outcome of this case and *Martin v. National Surety Company, supra* are different only because this Court held that Martin's knowledge at the time he was paid was the key issue and the Ninth Circuit holds that U.S. Bank's knowledge at the time of deposit, not the time it offset the funds to pay itself, is

the key issue. The logical progression of the constructive trust with which funds paid to a defaulting contractor are impressed is: (1) the funds come to the defaulting contractor impressed with a trust; (2) the trust is enforceable even though the defaulting contractor deposits it to his account; (3) once the bank has knowledge of the rights of a third party to that account, its right of offset is altered from the traditional right of offset because there is a lack mutuality between the customer and the bank in terms of their debts to each other. This alteration is due to the fact that now a third party with a claim to the funds in the account is the bank's creditor and unlike the depositor/borrower has no debt to the bank. This lack of mutuality has traditionally prohibited offset.

The Ninth Circuit's decision, that it is the bank's knowledge on the date of deposit that determines whether the bank can keep the funds, eliminates, as a practical matter, the surety ever being able to enforce a constructive trust against money in the contractor's account. The decision below eliminates the enforcement of a constructive trust because, as a practical matter, the only party available to notify the bank of the defaulting contractor's default is the surety and if the surety knew that a deposit was about to be made to the bank it would certainly stop the deposit, as opposed to advising the bank that a deposit was about to be made to a defaulting contractor's account and that it should be turned over to the surety.

These issues arise continually after the deposit has already been made without knowledge on the part of the bank. To do as the Ninth Circuit has done and make the date of deposit the date to test the bank's knowledge of the surety's claim makes irrelevant the fact that the surety can prove that at the time of the notation of the offset the bank had such knowledge as would bar its traditional right of offset. In the instant case we are dealing with a $280,319 check. Greater amounts are routinely involved

in federal project payments and have considerable impact on the surety's out of pocket expenses to complete or pay for work on a defaulted job.

As noted above the Fifth Circuit found the deposited funds of a defaulting contractor to be impressed with a constructive trust in *Pacific Indemnity Company v. Grand Avenue State Bank, supra. Id.* at 518.

Even prior to *Martin v. National Surety Company, supra* the case of *United States Fidelity and Guaranty Company v. City of Bristow,* 4 F.2d 810 (E.D. Okla. 1925) found that based upon the provisions of the surety bond application the assignment to the surety of all deferred payments, retained percentages and any and all monies and properties due at the time of such breach created an equitable lien on the property in favor of the surety and that this equitable right arose from the moment the suretyship relationship came into existence by virtue of the contract and posting of the bond.

In *Aetna Casualty Insurance Company v. Harvard Trust,* 344 Mass. 160, 181 N.E. 2nd 673 Mass. (1962) in reliance upon *Martin v. National Surety Company, supra* the court allowed the surety to recover the project payments made pursuant to an assignment to a bank: "of course, where the person receiving payment has notice of all the facts giving rise to the surety's interests, the money's paid over may be followed." *Id.* at 680.

The thrust of these cases is, that upon default of the contractor there is a right in the surety by virtue of its contract with the contractor to receive all payments then in the hands or control of the contractor as well as all amounts due or to become due. This right is commonly referred to as an equitable lien or equitable right of subrogation. In the instant case the surety's

rights are not only to progress payments and retention but to money of the contractor in the hands of third parties, such as money in the contractor's account at U.S. Bank, when such funds can be traced to a particular project payment.

CONCLUSION

While analysis of the issues herein depends on Washington law in so far as the elements of conversion and the nature of property interests are concerned, this case is not one that may be decided without reference to federal cases concerning sureties. The surety's rights as a federal surety, both before and after passage of the Miller Act, have traditionally been resolved by the federal courts and the body of surety law extant in the United States for federal projects must necessarily be uniform from state to state. A Miller Act surety must know that when he goes into federal court in the state of Washington that his equitable rights and remedies are the same in Washington as they will be in California, New York or Texas.

By the decision below, one universally recognized arrow from the surety's quiver, that of the equitable lien against the contractor's funds has been subtly eliminated in the Ninth Circuit while it still thrives in the First and Fifth Circuits. Not only has the decision below effected the surety's ability to enforce its constructive trust, but the decision below, while leaving the elements of conversion under Washington law in place, has eliminated the ability of a surety to prove a bank's conversion by allowing a bank to retroactively offset and thus claim that at the time of its offset (i.e. date of deposit) it had no knowledge that the funds belonged to another.

The reasoning of the First Circuit in *Insurance Company of North America v. Northampton National Bank, supra* in a footnote which states that "receipt of the funds" is the day of setoff not the day of acceptance of a deposit is much more

compatible with the history of the surety's rights, setoff and conversion than is the Ninth Circuit's recent modification.

Much confusion still exists in the relationship between the bank and the surety concerning funds in the contractor's account at the time of his default. Millions and millions of dollars are spent in bond premiums for sureties yearly. Sureties themselves spend millions and millions of dollars completing projects and paying unpaid subcontractors, suppliers and materialmen. Construction amounting to billions of dollars is undertaken on state and federal projects throughout the United States each year and yet the rules upon which these businessmen and government officials must operate are not yet clear. The result is of course that the risks are difficult for the surety to determine and the premiums must be raised and passed from the contractor to the governmental entities and ultimately the taxpayer.

This case, based on a straight forward and clear set of stipulated facts presents the Court the opportunity to resolve the conflicting claims between sureties and lenders as to funds in a contractor's account which at the time of the contractor's default have not been turned over to the surety nor paid to the lender and which have not been offset by the lender prior to notice from the surety of its rights.

In the real world sureties continue to notify banks of their rights to funds on deposit in contractor's accounts and banks continue, despite their knowledge of the surety's claims to exercise their offset powers. As pointed out by the Ninth Circuit in the instant case there is no controlling case entirely on point which covers the fact pattern in this case, which this writer suggests, is a recurring pattern and is the fact pattern in the majority of the bank/surety disputes concerning funds offset by a bank.

Respectfully submitted,

JOHN C. MERKEL
Attorney for Petitioner
999 Third Avenue
Suite 2525
Seattle, Washington 98104
(206) 389-8222

APPENDIX

APPENDIX A — OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT FILED APRIL 29, 1998

FOR PUBLICATION

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 95-35872

D.C. No.
CV-93-00705-TSZ

OPINION

RELIANCE INSURANCE CO., a Pennsylvania Corporation,

Plaintiff-Appellee,

v.

U.S. BANK OF WASHINGTON, N.A., a National Banking Association,

Defendant-Appellant.

Appeal from the United States District Court
for the Western District of Washington
Thomas S. Zilly, District Judge, Presiding

Argued and Submitted
December 10, 1996 — Seattle, Washington

Filed April 29, 1998

Appendix A

Before: John T. Noonan, David R. Thompson, and Andrew J. Kleinfeld, Circuit Judges.

Opinion by Judge Kleinfeld

* * *

OPINION

KLEINFELD, Circuit Judge:

This is a dispute between a bank and a surety over which of them gets a government payment into a defaulting contractor's bank account.

FACTS

The case was adjudicated on cross motions for summary judgment. The facts below are those set out in affidavits, stipulations, and other materials as to which there is no dispute.

Kruse Construction got a government contract to improve a Coast Guard station at Cape Disappointment, Washington. Because it was a federal project, laborers and materialmen were secured by a surety bond pursuant to the Miller Act, 40 U.S.C. § 270(a)(a)(2), instead of the mechanics liens they would have had if the project had been a private one. Reliance Insurance Company wrote the surety bond. U.S. Bank of Washington provided the construction loan. Pursuant to an approved assignment from the contractor to the bank, the government wired progress payments directly into the contractor's account at the bank.

The contractor ran into financial difficulties in the spring and early summer of 1992. By the first of June, numerous

subcontractors had given notice to the surety of unpaid claims. The contractor's cash flow problems were severe by mid-June.

The money at issue in this case was paid out June 19, 1992. On that date, the Coast Guard deposited $280,319 into the contractor's bank account by wire transfer. The bank knew on that date that the contractor was having financial problems, but did not know that subcontractors had not been paid. The surety knew on June 19 that subcontractors had not been paid, but did not know that the progress payment had been made.

Four days after the money was deposited, on June 23, the contractor declared itself in default. With the surety's cooperation, the contractor notified laborers and materialmen that it could not pay its bills. The contractor also notified the government that it was in default and consented to payment of any moneys due from the government to the surety instead of the contractor. On that day or the next, the surety notified the bank of its claim that the June 19 deposit should be disbursed to laborers and materialmen. The surety's interest was of course that whatever was paid out of the Coast Guard deposit in the bank to laborers and materialmen would reduce what the surety would otherwise have to pay them.

The bank took the position that it had first claim on the money. It decided to treat the June 19 progress payment as a setoff against what the contractor already owed the bank. Thus as a practical matter, the bank rather than the surety got all the benefit of the government's progress payment. The surety was stuck with paying the laborers and materialmen out of its own money, subject to its right to have the contractor indemnify it, an illusory right because the contractor was broke.

The surety sued the bank, on the theory that the surety should have had the benefit of the June 19 progress payment. The district

court granted summary judgment in favor of the surety. The bank appeals.

ANALYSIS

The district court, applying Washington law, held that the bank converted the money, because it knew on June 23 that the contractor was in default, and that as of that date, the surety had an equitable lien superior to the bank's. No party claims that genuine issues of material fact precluded summary judgment. The appeal questions application of the law to the undisputed facts. We find the questions exceedingly difficult, but respectfully conclude that in the circumstances, the bank was entitled to the offset it took, and reverse.

I. Choice of Law.

We agree with the district judge that the State of Washington was the correct source of law. There is not really a conflict between state and federal law, or between the law of one state or another. Nevertheless, we have found it necessary to consider choice of law so that we know where to look for authority. Choice of law and preemption analysis is used, not only to resolve conflicts, but to determine what one should read in order to find authority.

Displacement of state law by federal common law applies only in "few and restricted" areas. *O'Melveny & Myers v. FDIC*, 512 U.S. 79, 87 (1994). The Supreme Court has identified those areas as those involving a clear statutory directive to preempt state law, or a direct conflict between state and federal law, or "uniquely federal interests." *Boyle v. United Technologies Corp.*, 487 U.S. 500, 504 (1988).

Appendix A

The federal interest is unaffected by conflicting claims by the surety and the lender to a progress payment already made. *See Martin v. National Surety Co.*, 300 U.S. 588, 595 (1937). There is no preemption, no federal statutory directive preempting state law, and no direct conflict between federal and state law. State courts resolve such disputes far more frequently than federal courts, so state law is better developed. There is no great interest in national uniformity. Application of state law, producing uniformity within a state, makes it easier for small local firms to use the same practices and the same inexpensive forms on all their projects, and for those involved in the industry to use routine practices that can be administered by personnel untrained in the law. If legislative reforms are needed, state government is more accessible to the various interests. In disputes between lenders and sureties over payments already made by the federal government, state law rather than federal law is the proper source of authority.

II. Theories of recovery.

A. Conversion.

The bank argues that it could not be guilty of conversion of the surety's money, the theory on which it lost the case in district court, and we agree. "A conversion is the act of willfully interfering with any chattel, without lawful justification, whereby any person entitled thereto is deprived of the possession of it." *Public Utility District v. Washington Public Power Supply System*, 705 P.2d 1195, 1211 (Wash. 1985) (en banc).

It is doubtful whether the money in the bank account was a chattel that could be the subject of a conversion. It is of course a mere metaphor to speak of "the money in the bank account." In fact, the bank received a wire transfer from the government, and

entered a notation in its books acknowledging a debt from itself to the contractor for the amount of the transfer. The "money in the bank account" was nothing but an acknowledgment of indebtedness from the bank to its depositor. *Allied Sheet Metal Fabricators, Inc. v. Peoples Nat. Bank,* 518 P.2d 734, 738-39 (1963). Though money or a check could in some circumstances be the subject of conversion, *Public Utility District*, 705 P.2d at 1211, for example if someone wrongfully took a check from another's desk, the tort traditionally involves wrongful taking and carrying away of something tangible. Henry Winthrop Valentine, *Shipman on Common Law Pleading* 107-113 (1923). Except for special kinds of accounts in some jurisdictions, bank accounts generally cannot be the subject of conversion, because they are not specific money, but only an acknowledgment by the bank of a debt to its depositor. *See generally* Annot., Nature of Property or Rights Other Than Tangible Chattels Which May Be the Subject of Conversion, 44 A.L.R. 2d 927 (1955).

Even where money can be the subject of conversion, the cause of action does not lie "unless it was wrongfully received by the party charged with conversion, or unless such party was under obligation to return the specific money to the party claiming it." *Public Utility District*, 705 P.2d at 1211. The bank did not wrongfully receive the money; it was duly credited by the government to the bank pursuant to an approved assignment. Nor did the bank, when it received the money, June 19, have any obligation to deliver it to another. Knowledge of a lien against money does not make the recipient liable for conversion. *Davin v. Dowling,* 262 P. 123, 124 (Wash. 1927).

B. Subrogation.

The surety argues that it was subrogated to the contractor's right to recover progress payments from the time the contractor

defaulted, and that the contractor defaulted when it failed to pay subcontractors on time.

As of the time the bank received the money, and as of the time the bank setoff the progress payment against its loan to the contractor, the surety had not yet paid any subcontractors. Subrogation would mean that, having paid them, the surety would step into their shoes and take over their rights to recover the money they had been entitled to. But because the surety had not yet paid them, the unpaid subcontractors still owned the rights to payment. At common law, a surety does not become subrogated to its principal's right to payment from a third party until the surety performs the principal's obligation. Restatement (Third) of Suretyship & Guaranty § 27 (1995); Restatement of Security § 141 (1941); 73 Am.Jur.2d *Subrogation* § 26 (1974). Thus the surety in this case had not been subrogated to the contractor's right to the government progress payment. While we have found no Washington case on all fours, there is no reason to doubt that Washington applies the usual rule. *See Johnny's Sea Food Co. v. City of Tacoma*, 869 P.2d 1097, 1101 (Wash. Ct. App. 1994) (subrogation allows insurer to recover what it "has paid" its insured); *Jones v. Firemen's Relief & Pension Fund*, 738 P.2d 1068, 1071 (Wash Ct. App. 1987) (insurer is not entitled to subrogation until the insured has been fully compensated for his injuries).

The surety argues that it became subrogated to the contractor's right against the government, but that would not matter, because it is not making a claim against the government. The government had already paid out the money when the dispute arose. Nor could the surety's subrogation to the rights of the government to apply unpaid progress payments to the cost of completion, *see National Shawmut Bank v. New Amsterdam Cas.*

Co., 411 F.2d 843, 848 (1st Cir. 1969), matter, because the money was disbursed. Once the government has paid the contract proceeds to the bank, its interest in the proceeds and its right to have them applied to pay laborers and materialmen ceases to exist, so there is no longer a government right to which the surety can be subrogated. *Bank of Arizona v. National Surety Corp.*, 237 F.2d 90 (9th Cir. 1956).

C. Priority.

All of the surety's authorities are distinguishable, and therefore unhelpful for resolving a dispute between the surety and the bank after the funds have been paid to the lender. *Reliance Ins. Co. v. United States,* 15 Cl. Ct. 62 (1988), for example, deals with entitlement to funds still held by the government. *Massart Co. v. Mottner,* 105 B.R. 610 (W.D. Wash. 1989), is a claim by the surety against the contractor's bankruptcy estate, so it establishes a right against the defaulting contractor rather than against the lending bank. Likewise, in *Pearlman v. Reliance Ins. Co.*, 371 U.S. 132 (1962), the surety that had already paid the laborers and materialmen was entitled to the money the government paid to the contractor's bankruptcy trustee. Pearlman too thus has to be classed with the cases where the surety is claiming against the contractor's successor rather than the bank.

The surety argues that the contractor's bank account was impressed with a constructive trust in its favor from the time the contractor first breached its contract by failing to make timely payments to subcontractors. It is hard to make sense of a trust theory, because the bank account is merely an acknowledgment of a debt from the bank to the contractor. This is not a case where the lender, in a dishonest transaction, collected money from the government with knowledge that the contractor had promised the

surety to pay it into a fund for laborers and materialmen ahead of the lender. *Cf. Martin v. National Surety Co.*, 300 U.S. 588, 593-94 (1937). The bank received the wire transfer without any knowledge that would impose a trust on the funds at the time the bank received the transfer.

Each side argues equity, and each has a sensible argument based on equity. The bank knew that the contractor was in poor shape financially, and, though it did not know that subcontractors were not getting paid, it could have assured that they were by policing the loan more effectively. On the other hand, the surety knew that subcontractors were not getting paid, and could have disclosed the problem to the bank and caused the bank to police payments to the subcontractors. For that matter, the surety could have disclosed the problem to the government and arranged to have the subcontractors paid directly. The bank and the surety both contributed in essential ways to the project. Both had reasonable grounds for the procedures they used, and as a practical matter, disclosure may have been reasonably delayed out of concern that it would shut down the project and precipitate a failure that did not need to happen. Comparison of equities leads nowhere. Of course there is no authority for the attractive notion of splitting this loss between these two innocent victims.

The surety argues that the bank lost its setoff right once the surety asserted its claim, so the bank setoff came too late, citing *Peoples National Bank v. United States*, 777 F.2d 459 (9th Cir. 1985). In that case, we held that where the IRS levied on the bank account, the bank's as yet unexercised right of setoff could not defeat the tax lien. That case is distinguishable because it involved a levy. A levy is a seizure, not merely a claim. The authority more in point is *Allied Sheet Metal Fabricators, Inc. v. Peoples National Bank*, 518 P.2d 734 (Wash. App. 1974), which held that

the bank could apply its depositor's checking account balance to the depositor's note to the bank instead of paying outstanding checks with the money in the account. The Washington court held that that was an application of the general rule that the bank could setoff its indebtedness to the depositor against the depositor's debt to the bank. *Id.* at 739.

What we need, in order to resolve this case, is authority for how to resolve conflicting claims of the surety and the lender, when the lender, without fraud, has received the progress payment from the government. The authorities, in cases where the money has been paid to the bank by the government, favor the bank against the surety. *United States Fid. & Guar. Co.*, 129 F.2d 751, 755 (9th Cir. 1942), holds that when the bank receives the money from the government without notice or knowledge that it is part of a fund in which the surety has or may thereafter acquire a superior right, the surety is not entitled to recover the money from the bank. *See also Bank of Arizona v. National Surety Co.*, 237 F.2d 90 (9th Cir. 1956). Dicta from the First Circuit says "had the Bank received payment, it could not (absent circumstances amounting to fraud) have been divested by the surety." *National Shawmut Bank v. New Amsterdam Cas. Co.*, 411 F.2d 843, 848 (1st Cir. 1969). The phrase "circumstances amounting to fraud" may be an allusion to the egregious facts in *Martin v. National Surety Co.*, 300 U.S. 588 (1937). None of these cases is controlling, and the theories vary, but the outcome seems generally to be that where the bank and the surety contest entitlement to money that the government has disbursed to the bank, the bank prevails.

Professor Gilmore's great treatise likewise says that the cases generally hold that once the money has been paid over to the bank, the bank prevails against the surety:

Appendix A

> It is possible to divide the recent cases according to whether the money which is being fought over has been paid over to the bank or remains in the hands of the obligor: The bank has regularly been allowed to keep what it has received, and the surety has regularly been given a prior claim to the retained percentages and progress payments earned put not disbursed.

Grant Gilmore, *Security Interests In Personal Property*, 978 (1965).

We agree with Professor Gilmore that the equities are strong, equally strong, for both sides, so little is to be gained by arguing which deserves the money more. *Id.* at 979. Both are more or less innocent victims. The legal theories that can be constructed for each are somewhat metaphysical and indeterminate. Though no controlling case is entirely on point, holding for the bank, where the money has been paid into the bank, is more consistent with what the parties would likely predict based on past cases. A predictable result has the advantage that the parties can make reasonable financial calculations based upon it, and contract for a different result if they find that more efficient. We therefore conclude that the bank was entitled to summary judgment.

REVERSED.

APPENDIX B — JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT FILED APRIL 29, 1998

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

NO. 95-35872
CT/AG#: CV-93-00705-TSZ

RELIANCE INSURANCE CO., a Pennsylvania corporation,

Plaintiff - Appellee

v.

U.S. BANK OF WASHINGTON, N.A., a national banking association

Defendant - Appellant

JUDGMENT

APPEAL FROM the United States District Court for the Western District of Washington (Seattle).

THIS CAUSE came on to be heard on the Transcript of the Record from the United States District Court for the Western District of Washington (Seattle) and was duly submitted.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this cause be, and hereby is REVERSED.

Filed and entered — 4/29/98.

APPENDIX C — TRANSCRIPT OF PROCEEDINGS DATED MAY 4, 1995

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

Case C93-705Z

RELIANCE INSURANCE COMPANY, a Pennsylvania corporation,

Plaintiff,

vs.

U.S. BANK OF WASHINGTON, N.A., a national banking association,

Defendant.

RULING ON MOTIONS

on May 4, 1995, before the Honorable Thomas S. Zilly, United States District Judge, at the United States Courthouse, Seattle, Washington.

* * *

[2] Seattle, Washington; Thursday, May 4, 1995

THE COURT: Thank you, counsel. This is an action by a Miller Act surety to recover from the bank payments traceable under a construction project. The facts basically are not in dispute here. The law is greatly disputed by the parties.

Appendix C

The parties have filed a stipulation regarding exhibits and certain factual stipulations which the Court has reviewed at some length. The plaintiff Reliance Insurance Company issued a performance and payment bond to Kruse Construction, which was the contractor for a United States Coast Guard project. The bonds required under the Miller Act.

The defendant U.S. Bank financed the contractor's operations including the U.S. Coast Guard project. The contractor and the bank arranged for contract payments to be wired directly into the contractor's account with the bank. At issue here is approximately $280,000, the payment from the U.S. Coast Guard which was wired into the contractor's account.

The surety learned of the contractor's financial difficulties during a meeting on June 22nd, 1992. What they learned is not particularly important. What is important is what the surety or the contractor told the bank.

As to that, we have undisputed facts that on June 23, 1992, the bank received exhibit 21 to the stipulation regarding exhibits, which is docket number 18. That letter dated June 23 transmits various financial information and asks for a meeting [3] with the bank.

The financial information contains two draft cash flow analyses, one at page 163 indicating a net projected cash flow deficit of $1,547,000. And when I during questioning referred to a half a million dollars, I was in error. It was a million and a half. And the second working copy analysis also having the same date shows a deficit of $1,435,000.

In addition, this packet of material which the bank received had a letter from Mr. Fjellstad, the manager of the bond claims

department of Reliance Insurance Company, to Mr. David Trachtenberg of Oles, Morrison and Rinker, the attorney for the contractor, which indicates that there is enclosed a letter which the construction company must send out to all of its creditors.

That draft of the letter was also sent to the U.S. Bank. And it is not signed, it is a draft of the letter, but it clearly puts U.S. Bank on notice that due to financial difficulties beyond the control of the contractor, they are unable to pay labor and materialman's bills incurred on the job and that they relinquish or will relinquish any claim to any amounts due or thereafter to become due under the contract.

Also not disputed is the fact that on June 23rd at approximately 2:15, Mr. Fjellstad called. Mr. Bob Rutledge of the U.S. Bank. Now, the parties have agreed that Mr. Rutledge was the officer at the bank in charge of the Kruse loans during May and the first four weeks of June 1992. That is stipulated fact [4] number 6.

Mr. Fjellstad states in his affidavit, which is docket number 13, that the telephone call was primarily concerned with Reliance's right to have the recent payment to the GKCC's account applied to the Ilwaco debts and to advise the bank that Reliance's position on all other project funds was that such funds now belonged to Reliance.

Now, that statement is not rebutted by the affidavit of Mr. Rutledge. Mr. Rutledge files his affidavit which I've also reviewed, docket number 19, and he acknowledges that there was a telephone conversation that he had with Mr. Fjellstad of Reliance. And in Mr. Rutledge's own words, he states, "I learned that Reliance was attempting to tell Kruse how to spend the proceeds of the

Coast Guard payment and was attempting to persuade Kruse to assign all future payments on all of his government contract jobs to reliance as his surety."

Then it goes on to say he didn't learn until Thursday, June 25th how Kruse responded to Reliance's demands. Those are the facts as to the knowledge the U.S. Bank had at the time.

On June 24th, the bank directed an offset of $280,319 from Kruse's general account balance to lower the outstanding balance on the line of credit; stipulated fact number 7.

Obviously, the dispute is whether or not under these facts which are not in dispute, the surety company has an equitable lien which is superior to the security interest that the bank has [5] under article IX.

Under Washington law, a conversion is the act of willfully interfering with any property without lawful justification where any person entitled thereto is deprived of possession of it. To prove conversion under Washington law, the surety must prove, one, that the bank wrongfully received the funds and, two, the surety had some property interest and the surety is entitled to immediate possession. *PUD No. 1 v. WPPSS,* 104 Wn.2d 353 at 378 to 380.

Under Washington law, the bank "wrongfully received" — and I'm not making a moral judgment here; I'm making a legal determination — but the bank wrongfully received the $280,000 if it knew of the contractor's default when it received payment.

A creditor wrongfully receives payment from a contractor when the creditor receives the payment with knowledge or notice

of a Miller Act surety's equitable lien on the funds. *Martin v National Surety Company,* 300 U.S. 588, 598 (1936). However, it is not wrongfully received if the creditor receives payment without knowledge of the Miller Act surety's equitable lien. *Bank of Arizona v. National Surety Corporation,* 237 F.2d 90 at 96 (9th Cir. 1956).

Under the facts here, it is the Court's view that on the undisputed evidence the bank knew on June 23 of 1992, as a result of the information it received in writing, exhibit 21 to the facts, and as a result of the information the bank received in the [6] telephone conversation which is outlined in both Mr. Rutledge's affidavit and Mr. Fjellstad's affidavit of the contractor's default. The bank had actual knowledge that the contractor was in default. That the contractor anticipated negative cash flow on the jobs that were outstanding of approximately 1,500,000. That the surety was demanding the contractor write all of its creditors and indicate the surety had taken over. And that Reliance was claiming the funds belonged to Reliance, held by the U.S. Bank.

Under those circumstances, it is my view that the Reliance had an equitable lien. The equitable lien was superior to the secured lien of the bank and that the Reliance Insurance Company is therefore entitled to recover on this claim.

I am not satisfied that the law requires Reliance not only to give actual notice to the bank, but to actually pay out on the claim. I don't believe that is the law.

It will therefore be the Court's decision in this case that the motion by the plaintiff Reliance Insurance Company for summary judgment, docket number 12, for claims of conversion be granted.

And that the clerk is directed to enter judgment in favor of the plaintiff and against the defendant with costs. The cross-motion by the defendant bank for partial summary Judgment to dismiss, docket number 16, is obviously denied.

I appreciate all of the briefing. These are difficult issues. I am persuaded that there was an equitable lien there. [7] And I'm persuaded that it trumps the security interest of bank because the bank did not setoff until the following day after actual notice.

I am not making any findings with respect to whether or not the bank should have known. In other words, I am finding that they actually knew based on the undisputed facts. I am not finding that the law would go the next step and say, well, if they didn't actually know, they should have known, somehow the equitable lien would still prevail. I am not sure that that would be the result.

But in any event, I am finding actual knowledge on facts which are really not in dispute here. And clearly the bank's conduct within a 24-hour period given all the information they had clearly demonstrates to me that they had actual knowledge and they did everything possible to try and protect their interests. And I don't blame them for trying. But I believe under the law the equitable lien is superior.

This is the only issue in the case, is it not, the dispute on who owns this money?

MR. MERKEL: That's correct, Your Honor. We have reached a settlement on the other claim having to do with accounting of the retention. I've got an order of dismissal that I'm going to file on that account.

THE COURT: It's been stipulated. Is that what you're telling me?

[8] MR. MERKEL: Yes.

MR. VAN DUSEN: That's correct.

THE COURT: Then we can just say on the record there are no other issues that are outstanding. Is that correct?

MR. MERKEL: That is correct.

MR. HACKETT: That's correct.

THE COURT: And the Court can then enter judgment dismissing all claims based on the ruling of the Court today and the agreement of the parties with respect to the remaining claims. Is that fair?

MR. HACKETT: Yes.

THE COURT: All right. Thank you. We'll be in recess. (At 2:34, court was in recess.)

* * *

APPENDIX D — ORDER OF THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT DENYING PETITION FOR REHEARING EN BANC FILED JUNE 16, 1998

NOT FOR PUBLICATION
IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 95-35872

D.C. No. CV-93-00705-TSZ

RELIANCE INSURANCE CO., a Pennsylvania corporation,

Plaintiff-Appellee,

v.

U.S. BANK OF WASHINGTON, N.A., a National Banking Association,

Defendant-Appellant.

Before: NOONAN, THOMPSON, and KLEINFELD, Circuit Judges.

ORDER

The panel has voted to deny appellee's petition for rehearing. Judge Thompson and Judge Kleinfeld have voted to reject the suggestion for rehearing en banc and Judge Noonan so recommends.

Appendix D

The full court has been advised of the suggestion for rehearing en banc, and no active judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35(b).

The petition for rehearing is DENIED and the suggestion for rehearing en banc is REJECTED.

OPPOSITION

BRIEF

Supreme Court, U.S.
FILED
SEP 25 1998
OFFICE OF THE CLERK

No. 98-358

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1997

RELIANCE INSURANCE CO.,
Petitioner,

v.

U.S. BANK OF WASHINGTON, N.A.,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

PETER S. HOLMES
WILLIAM H. WALTERS*
MILLER, NASH, WIENER,
HAGER & CARLSEN LLP
111 S.W. FIFTH AVENUE
PORTLAND, OREGON 97204-3699
(503) 224-5858

ATTORNEYS FOR RESPONDENT
U.S. BANK OF WASHINGTON, N.A.

* *Counsel of Record*

15 pp

TABLE OF CONTENTS

	Page
Table of Contents	i
Table of Authorities	ii
Reasons for Denying the Writ . . .	2
1. There is no conflict among the circuits . . .	2
2. The rule that petitioner advocates to resolve the claimed intercircuit conflict would not decide this case differently .	5
Conclusion	7

TABLE OF AUTHORITIES

Page

Cases

Ins. Co. of North America v. Northampton Nat. Bank, 708 F.2d 13 (1st Cir. 1983) . . 3

Martin v. National Surety Co., 300 U.S. 588 (1937) 4

Pacific Indem. Co. v. Grand Ave. State Bank of Dallas, Texas, 223 F.2d 513 (5th Cir. 1955) . . 3

Public Utility District v. Washington Public Power Supply System, 705 P.2d 1195 (Wash. 1985) . . . 6

Reliance Ins. Co. v. U.S. Bank of Washington, N.A., 143 F.3d 502 (9th Cir. 1988) 2, 4, 5, 6

No. 98-358

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1997

RELIANCE INSURANCE CO.,
Petitioner,

v.

U.S. BANK OF WASHINGTON, N.A.,
Respondent.

BRIEF IN OPPOSITION TO
PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

In this litigation, petitioner and respondent cross-moved for summary judgment in the district court on petitioner's state law claim that respondent had converted certain funds to which petitioner claimed the superior right. The district court granted summary judgment for petitioner, and respondent appealed. The circuit court reversed,

concluding that respondent was entitled to summary judgment.[1]

REASONS FOR DENYING THE WRIT

1. **There is no conflict among the circuits.**

There is no intercircuit conflict because this case is governed by Washington law. The circuit court so held:

> "We agree with the district judge that the State of Washington was the correct source of law," Petitioner's Appendix A at 4a; *Reliance Ins. Co. v. U.S. Bank of Washington, N.A.*, 143 F.3d 502, 505 (9th Cir. 1998),

---

[1] Respondent U.S. Bank of Washington, N.A., is the predecessor by merger to U.S. Bank National Association, a subsidiary of U.S. Bancorp. The nonwholly owned subsidiaries of U.S. Bank National Association and U.S. Bancorp are numerous; a list is appended. See Supreme Court Rule 29.6.

and petitioner does not dispute that a state law claim for conversion is at issue.

In the petition's "Conclusion," petitioner submits that rights of a Miller Act surety "have traditionally been resolved by the federal courts." (Pet. at 20.) The opinions of the First[2] and Fifth[3] Circuits--which petitioner asserts conflict with the decision below--make it clear, however, that these courts applied *state* law, respectively the law of Massachusetts and that of Texas.

It would be quite another matter to argue that the circuit court wrongly applied Washington law because conflicting

---

[2] *Ins. Co. of North America v. Northampton Nat. Bank*, 708 F.2d 13 (1st Cir. 1983).

[3] *Pacific Indem. Co. v. Grand Ave. State Bank of Dallas, Texas*, 223 F.2d 513 (5th Cir. 1955).

federal law should apply in this case. But petitioner makes no such argument.[4]

Petitioner's assertion that "[t]here is a direct conflict between decisions of the First and Fifth Circuits" (Pet. at 7) is without substance.[5]

---

[4] Indeed, petitioner concedes that the circuit court "le[ft] the elements of conversion under Washington law in place." (Pet. at 20.)

[5] Petitioner's secondary basis for review is equally unavailing. The circuit court factually distinguished this case from the rather special facts of *Martin v. National Surety Co.*, 300 U.S. 588 (1937)

> "This is not a case where the lender, in a dishonest transaction, collected money from the government with knowledge that the contractor had promised the surety to pay it into a fund for laborers and materialmen ahead of the lender." Petitioner's Appendix A at 8a-9a; 143 F.3d at 507.

2. **The rule that petitioner advocates to resolve the claimed intercircuit conflict would not decide this case differently.**

Respondent received the money in question on June 19, 1992.

> "The money at issue in this case was paid out June 19, 1992. On that date, the Coast Guard deposited $280,319 into the contractor's bank account by wire transfer." Petitioner's Appendix A at 3a; 143 F.3d at 504-05.

On that date, respondent received the wire transfer and "entered a notation in its books acknowledging a debt from itself to the contractor for the amount of the transfer." Petitioner's Appendix A at 6a; 143 F.3d at 506. Under Washington law, "[t]he 'money in the bank account' was nothing but an acknowledgment of indebtedness from the [respondent] to its depositor." Petitioner's Appendix A at 6a; 143 F.3d at 506 (citation omitted).

Under Washington law, there can be no conversion of money "'unless it was

wrongfully received by the party charged with conversion, or unless such party was under obligation to return the specific money to the party claiming it.'" Petitioner's Appendix A at 6a; 143 F.3d at 506 (quoting *Public Utility District v. Washington Public Power Supply System*, 705 P.2d 1195, 1211 (Wash. 1985)).

The circuit court rejected petitioner's conversion claim in part because:

> "[Respondent] did not wrongfully receive the money; it was duly credited by the government to the bank pursuant to an approved assignment. Nor did [respondent], when it received the money, June 19, have any obligation to deliver it to another." Petitioner's Appendix A at 6a; 143 F.3d at 506.

Thus, even if the Court were to accept review and find a basis on which to follow petitioner's understanding of the cited decisions of the First and Fifth

Circuits and impose an equitable lien that could take priority over respondent's claim to the money at issue, this would *not* disturb the result below.

CONCLUSION

For these reasons, the petition for certiorari should be denied.

Respectfully submitted,

WILLIAM H. WALTERS
Counsel of Record

PETER S. HOLMES
Miller, Nash, Wiener,
Hager & Carlsen LLP
111 S.W. Fifth Avenue
Portland, Oregon 97204
Telephone: (503) 224-5858

Attorneys for Respondent

September 28, 1998

APPENDIX

SUPREME COURT RULE 29.6
DISCLOSURE STATEMENT

A. Nonwholly owned subsidiaries of U.S. Bank National Association:

AEG Acquisition Corp.
Aspen Park Limited Partnership
U.S. Northwest Alliance L.L.C.
Downtown Mall Associates Limited Partnership
Bonita Packaging Products, Inc.
Candlewood Investors
Capital Fund 85 Limited Partnership
Downtown Capital Corporation
Eagles Auditorium Limited Partnership
Housing Capital Company
Integrion Financial Network, L.L.C.
MECA Software, L.L.C.
First LaCrosse Properties
First Minneapolis - Hines Company
Harbinger EDI Services
Mercy Housing II Limited Partnership
Mercy Housing III Limited Partnership
Minbanc Capital Corporation
North Idaho II Limited Partnership
Oak Leaf Village of St. Cloud Limited Partnership
Oregon Equity Fund Limited Partnership
Rohlffs Manor III Associates
Security Financial Center of St. Cloud Partnership
St. Paul Progress Corporation
Village Park Housing Associates
Willowshade Associates

B. Nonwholly owned subsidiaries of U.S. Bancorp:

Briarwood Subdivision, Inc.
Business Health Care Action Group, Inc.

First Group Royalties, Inc.
Metro Plaza Partners
Private Export Funding Corporation
Provident Trust Company
SWH&K Partnership
Androy Hotel
Anoka County Capital Fund, LLC
Bull Durham LP
Chicago Equity Fund 1995 LP
Chicago Equity Fund 1996 LP
Chicago Equity Fund 1997 LP
Clyburn Village LLLP
Creamette Historic Apartments Limited Partnership
Dakota County Capital Fund
Dakota Equities LP
Eagan Family Housing LP
Foxcrest LP
Gardner Hotel Limited Partnership
Grand Valley Apts. Limited Partnership
Hastings Family Housing LP
Hausmann-Schoeer LP
Housing Equity Fund of WI - 1989 Fund
Lakeville Family Housing LP
Metropolitan Low-Income Neighborhood Housing Limited Partnership I
Metropolitan Low-Income Neighborhood Housing Limited Partnership II
Mercy Idaho IV LP
National Equity Fund - 1992 LP
National Equity Fund - 1993 LP
National Equity Fund - 1994 LP
National Equity Fund - 1995 LP
National Equity Fund - 1996 LP
National Equity Fund - 1997 LP
NEB Equity Fund VI LP
Nebraska Affordable Housing LP - 1993 Fund
Nebraska Affordable Housing LP - 1994 Fund
Nebraska Affordable Housing LP - 1995 Fund

Nebraska Affordable Housing LP - 1996 Fund
Nebraska Affordable Housing LP - 1997 Fund
North Avenue Commerce Center, LLC
Oak Manor LP
Richmond Apartments LP
Sioux Falls Housing Equity Fund
Sun America 67 Partners
Sun America Affordable Housing #71
Woodfield Apartments LP
YW Village East, LP
YW Village West, LP
901 N. 35th St. LP
FBS Venture Capital Company
FBS Small Business Investment Co. Ltd.
Mizar, Inc.
Zapp Bank Plaza Partnership
Bayview Apartments Limited Partnership
Berry Ridge Limited Partnership
Oregon Hotel Limited Partnership
Oregon Investors III Limited Partnership
Pacific Crest Associates Limited Partnership
Lyon Building Limited Partnership
1000 Virginia Limited Partnership
Willow Creek Commons Apartments Limited Partnership
Ariel Glen Limited Partnership
Harvard Street Partners Limited Partnership
Harvard Street Partners II Limited Partnership
Morrow Estates Associates Limited Partnership
California Investors XV
Brandenwood Associates
Eaton Housing Improvement Program
Fawnbrook Limited Partnership
Fawnbrook II Limited Partnership

Graham Apartments Limited Partnership
Cherry Ridge LIH Limited Partnership
Heritage Place Apartments Limited Partnership
King's Garden Limited Partnership
Bethany Meadows LIH, Limited Partnership
McKenzie Meadow Apartments Limited Partnership
Meadowbrook Apartments Limited Partnership
Heritage Heights, Limited Partnership
Westfall Village, Limited Partnership
St. James Housing Limited Partnership
St. John's Common Apartments Limited Partnership
Oregon Investors I Limited Partnership
KCHA-Woodridge Park Limited Partnership
Dawson Park Limited Partnership